PRESERVER PARTNERS

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Inflation and Its Effects on Investments

The lack of inflation in recent years, despite accommodative monetary and fiscal policy, has been an interesting investment phenomenon. In this white paper, we will discuss factors driving inflation trends, current inflation expectations and investment implications under different inflation scenarios.

Two commonly referenced metrics of U.S. inflation are the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) index. For a quick overview, CPI (specifically the CPI-U) tracks 211 goods and services across 38 geographic areas, but does not take into account personal income, employer paid-benefits, or investment assets like stocks, bonds, and real estate. The PCE index accounts for approximately two-thirds of domestic spending and determines how much of earned income is spent on current consumption, while also not accounting for investment assets like stocks, bonds, and real estate. Over the last three years, both measures have increased at a moderate pace, with the CPI-U averaging 1.92% and the PCE index, averaging 1.84% based on monthly data and a year-over-year comparison.

The growth in both measures has been largely driven by a combination of economic growth and accommodative fiscal policy. Economic growth has been moderate over time with periods of inflation, like 2018 where inflation surpassed the Federal Reserve's target of 2.00%, followed by years like 2020, where economic shutdowns in response to COVID-19 produced disinflation.

In 2020, there was safe-haven demand for the U.S. Dollar, which effectively lowered the price of imports. As lockdowns eased, the relative value of the U.S. Dollar to other global currencies retreated to levels last seen in 2018.

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In September 2020, the Federal Reserve announced that it would keep interest rates near zero for "some time" until the economy generates full employment and inflation is "moderately" above the 2.00% target. The Federal Reserve's current estimates project that core inflation will return to 2.00% on a full-year basis by 2023.

Today, there are multiple reasons to believe inflation may not rise sharply. COVID-19 has not dissipated and the world is still waiting on a significant vaccine and medical treatments to allow individuals and businesses to resume "normal" activities. As the world waits, the global economy may experience more recessionary headwinds including high unemployment and weak aggregate demand. If that is the case, both the recession itself and upward pressure on the U.S. Dollar would drive inflation down.

Once the global economy finds a stable foundation, it is likely that inflation will rise as economies reopen and global trade resumes. Unemployment has historically fallen after recessions, which is typically a tailwind for wage inflation.

For investors, these inflation scenarios have different implications for U.S. Treasuries, corporate bonds, U.S. stocks, real estate, and commodities. If we were to enter another recessionary environment with low inflation and no further fiscal or monetary stimulus, we would likely see negative price pressure for global stocks, corporate bonds, real estate, and commodities, while safe-haven assets such as the U.S. Dollar and U.S. Treasuries would increase in value.

If we experience higher inflation, longer-term interest rates would likely increase to the detriment of longer-duration U.S. Treasuries and corporate bonds, while most U.S. stock sectors, real estate, and commodities would perform well.

Going forward, it will be important to monitor macro-economic trends. Adjustments to fiscal and monetary support, more economic lockdowns due to subsequent waves of COVID-19, and meaningful movements in the U.S. Dollar will affection inflation rates and potential returns for many asset classes.